Market Insight

PALMER SQUARE
CAPITAL MANAGEMENT

July 2012

from Montage Investments

Investing in Today's Environment – Are CLOs an Attractive Credit Investment?

Executive Summary

In today's low interest rate environment, investors are frequently searching for asset classes which offer not only yield, but also some price protection or benefit were interest rates to begin rising. Most frequently, investors cite three types of credit that can achieve these goals: floating rate bank loan funds, high yield bonds, and convertible bonds. Palmer Square is quite active in all three of those credit areas and believes all are important tools for portfolio construction. For this piece, we would like to highlight a fourth area within credit that is often overlooked or completely misunderstood since the 'credit crisis' that disrupted global markets in 2008: Collaterized Loan Obligations ("CLOs"). In this paper, we will provide a brief description of a basic CLO; discuss the opportunity and specific types of CLO investments which we believe offer strong risk/return characteristics; and finally, provide a general framework for CLO manager selection.

Before outlining the attractive risk-adjusted opportunity we see within CLO investing, it is imperative to highlight that investors still need to exercise caution and be selective with how they would implement an allocation. Global macro risks can distort fundamentals in the short-term and drive prices lower. In addition, during times of stress, certain areas of credit become less liquid and bid/ask spreads increase significantly. As a result, Palmer Square believes gaining exposure to this type of credit is best done by allocating to an active fund manager who has been through credit cycles, has managed credit risk, and can operate with a flexible mandate.

Introduction

A Collaterized Loan Obligation ("CLO") is a structured credit product managed by an institutional credit manager that securitizes a diversified pool of bank loans into multiple classes of notes that are then sold to a wide array of investors. As shown in Exhibit 1 below, a typical CLO has the following capital structure: senior notes, mezzanine notes, and equity. Outside of the equity piece, each 'slice or portion' of the CLO capital structure pays a certain interest rate to its investors. Investors can decide to purchase any portion of the CLO. For example, an insurance company or bank can opt to invest in the most senior piece in the capital structure which will offer the lowest return and lowest risk, or a hedge fund may decide to invest in the equity portion that will receive all of the cash flows from the underlying bank loans which they are not obligated to pay-out to the senior and mezzanine tranches. In essence, the equity portion has all of the upside if the institutional credit manager manages the CLO well. In summary, CLOs offer investors access to a diversified and actively managed portfolio of loans in a single investment that can provide enhanced returns. It is important to note that the underlying assets in CLOs are loans. Of particular importance to investors, bank loans have historically been a relatively stable asset class, experiencing lower credit losses than bonds or other esoteric securities.

Exhibit 1 – Sample CLO Capital Structure

Assets	Liabilities / Equity
$400 million Leveraged Loans	**$265 million** - Class A Senior Notes
	$95 million - Class B Mezzanine Notes
	$40 million - Income Shares/Equity

Source: Palmer Square

CLO Investing – Potential Upside in Today's Environment?

Following the 2008 credit crisis and the broad-based rally in risk assets that started in 2009, the marketplace surrounding CLOs continues to suffer from a significant supply/demand imbalance. Many of the usual investors such as European and Japanese banks, structured vehicles, and proprietary Wall Street desks are no longer materially active, while a huge supply of CLOs are still available. That supply consists of not only pre-2008 underwritten securities of varying levels of quality, but also newly underwritten CLOs. This dislocation has created investment opportunities across all of the different debt and equity portions of CLOs. For example, in the mezzanine portion of CLOs (i.e., BBB/BB rated bank loans), significant yields of 8-10% can be obtained on top of potential price appreciation given many securities are trading at stressed levels. For lower quality opportunities, including the purchase of equity tranches, yield opportunities are currently 15-20%. Within all of credit, Palmer Square believes certain areas within CLOs offer one of the best buying opportunities since high yield in early 2009.

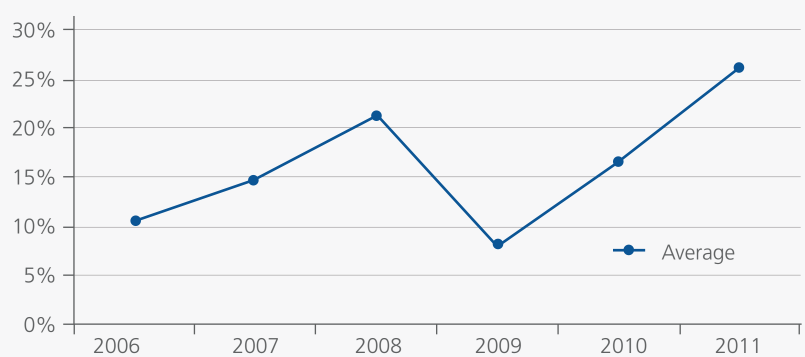
Investment Ideas:

CLO Equity Has Provided Investors with High Income

According to JPMorgan research, the universe of CLO equity is $340 billion, and even through the volatility of 2008 and 2011, the average cash flow return from 2006-2011 was 17% per annum (please refer to Exhibit 2 below). In 2011, the cash flow return to equity tranches of CLOs was 26%. As a general investment comparison, in 2011, the S&P 500 and MSCI World (ex US) returned 2.1% and -11.8%, respectively.

While these returns are certainly significant, Palmer Square believes that CLO equity issued pre-2008 ("Vintage CLO Equity") still remains inexpensive. First, Vintage CLO Equity was issued in a very favorable debt financing environment so most of the capital structure (i.e., senior and mezzanine) pays out low yields to investors. As a result, the equity portion of the CLO structure receives tremendous upside after all the senior and mezzanine noteholders receive their coupons. Second, many of the underlying assets are loans which were sold with significant LIBOR floors meaning that the loans are paying artificially higher yields compared to what the equity holders have to pay existing investors. As a result, the residual cash flow to equity can be substantial, averaging 7.5-10% per quarter in some cases. Yes, that is per quarter! Even with market volatility, the short duration nature of cash flow payable offers tremendous cushion from price declines. Moreover, many of these offerings are trading at depressed prices given the market dynamics we discussed earlier. Even assuming moderate default scenarios, many equity pieces still return capital.

Exhibit 2 – Annual average cash flow of US CLO equity, 2006-2011



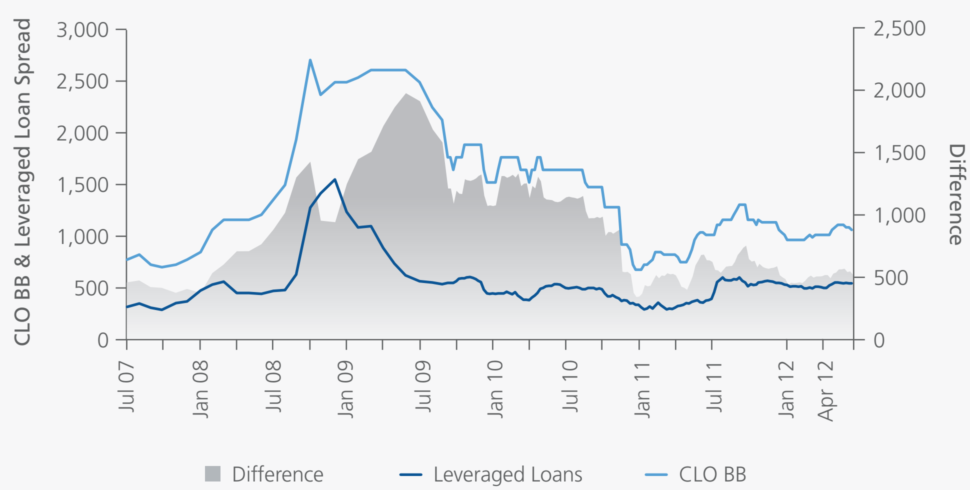
Source: J.P. Morgan, Intex. Outstanding equity of 2005 to 2011 vintages.

Newly-issued Mezzanine Notes Offer Significant Spreads

As investors may know, despite CLOs surviving as an asset class in 2008 and equity portions delivering strong returns, many debt holders within the senior and mezzanine levels suffered losses. With newly issued CLO senior and mezzanine notes, investors have been demanding more profit and structural protection. As a result, newer CLO transactions are less leveraged, more restrictive, and are rated more highly. In addition, only the best CLO managers with long track records managing credit are able to issue new CLOs.

As we have written about before, Palmer Square continues to overweight credit given the current environment of expected low default rates, solid corporate balance sheets, and finally, significant yields. This credit thesis applies to newly-issued mezzanine notes as well. With regard to the yields on newly issued mezzanine notes, BB debt portions currently offer spreads over LIBOR of 850 bps or more. As a comparison, traditional BB leveraged loans today offer spreads over LIBOR of 420 bps. For a broader market context, please see Exhibit 3 below which illustrates the premium return that secondary CLO BB notes have offered over time relative to traditional leveraged loans.

Exhibit 3 – CLO BB vs. Leveraged Loan Spread (bps)



Source: J.P. Morgan, S&P LCD: Data from July 31, 2007 until July 12, 2012.

Manager Selection Plays a Key Role

The asset manager, with broad discretion to purchase and trade the underlying loans, plays a key role in a CLO's structure. Similar to a mutual fund manager, a CLO manager's key responsibilities generally include: selecting assets for the portfolio, determining the timing of sale and purchase of assets, accessing the quality and adequacy of the collateral and ensuring compliance with the investment guidelines. In addition, CLO managers usually hold and invest in a portion of the CLO equity to better align interests. Ultimately, the skill of the

CLO manager will play the most important role in whether the various portions of a CLO successfully meet their risk/return targets.

How do you go about selecting a CLO manager to take advantage of the market dislocation we described above? While the following list is not exhaustive, key elements in the due diligence process include: credit expertise, structural expertise, financial continuity, capital invested alongside other CLO investors, and track record. For Palmer Square, we seek to identify managers who excel in these five categories. In our opinion, we believe we have been successful investing in opportunities where we align our funds with blue chip CLO managers who not only have deep credit research, but also understand how to manage the CLO structure. Our comfort is typically enhanced by a long track record of not only serving investors well, but also investing alongside investors to align interests. Finally, we work to leverage our credit expertise and manager relationships as a competitive advantage.

In closing, please note that while manager selection is absolutely critical, investors should also make sure to analyze other aspects of a CLO investment including, but not limited to: call protection, liquidity, collateral quality and subordination levels.

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